

SECRET

Security Implications of Lower Oil Prices

The decision by Norway to make oil price decisions daily--a move that may be followed by the United Kingdom, which recently switched from quarterly to monthly pricing, and Nigeria--is symptomatic of escalating downward pressure on oil prices. The Norwegian and UK decisions in effect tie their official prices more closely to the spot market. While I don't expect a steep decline in the near term, the demonstrated inability of OPEC to cut back production in the face of the global glut may mean a price drop of a few dollars to perhaps \$10 per barrel by spring.

There would certainly be much benefit in such a decline; most of the world's \$1 trillion plus annual energy bill is tied to oil prices. A decline in the import portion of this bill would give a much-needed fiscal boost to the Western economies and allow them to broaden their gains in the current recovery. Losses in energy-related taxes would certainly be more than offset by the broader financial pluses.

Regrettably, the security implications, both near-term and long-term, are on balance negative.

- In Europe, the decisions to further develop North Sea gas and discussion of other alternatives such as Algerian supplies would likely be sidetracked. Soviet gas already retails for less than residual fuel oil, and North Sea development and transportation systems would be expensive.
- In the Middle East, the financial blows would fall most heavily on the more moderate Arab states and, from there, trickle down in the form of reduced aid to those moderate countries they support. It would also raise the possibility of an all out effort by a financially struggling Iraq to disrupt Persian Gulf shipping, with obvious implications for a wider war. Iran itself could offset lower prices with higher production.
- Closer to home, Mexico's financial recovery program would suffer a serious blow that could also translate into reduced spending for badly needed exploration and development of oil supplies for future export.

Over the longer term, a reduction in energy prices would certainly lead to an increase in reliance on Persian Gulf oil exports as the more expensive secondary and tertiary oil recovery operations in the West fall by the wayside and oil demand picks up in response to the lower price.